ESG is the boardroom giant that keeps on growing: Legislative considerations

Susanne McMenamin, Garret Farrelly and **Tara Doyle** of **Matheson** discuss the role of corporate governance in ESG and explain why boardrooms needs to be proactive, prepared and well-informed when it comes to successful ESG reporting.

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Environmental, social and governance (ESG) issues have catapulted up the corporate agenda in recent years and Europe has been the driving force behind many policy-making and legislative developments.

In July 2021, the European Commission (the Commission) announced a renewed Sustainable Finance Strategy aiming to direct more investment towards environmentally sustainable activities. This increased focus is not a wholly EU affair but can also be seen across the water in the US. The SEC has frequently signalled that ESG sits high on its policy agenda with indications that climate risk, human capital, workforce diversity, corporate board diversity and financial sustainability are emerging as key areas of focus.

While the concept of ESG has been around for some time, it began to garner significant traction at the dawn of the Covid-19 pandemic. ESG is a framework for ensuring that business practices have regard for (1) the environment ('E') in which they operate, including energy resources used, output of waste and general impact on climate; (2) social issues ('S'), such as employee health and safety, human rights, data privacy of customers and employment practices; and (3) governance ('G') of the business in an environmentally and socially sustainable manner, having regard to such issues as the supply chain of the organisation, corporate governance and risk management, and compliance.

In November 2021, the Irish Institute of Directors, in conjunction with the Diligent Institute, released findings of a survey entitled 'Pandemic Pushes ESG Up the Agenda in Irish Boardrooms – ESG Leadership Survey' (the Survey). The Survey revealed a significant increase in the discussion of ESG matters in Irish boardrooms since the onset of the pandemic, a trend evident in boardrooms right across the globe. In the Survey, 82% of respondents indicated that ESG issues are now discussed at board level at least annually,

Susanne McMenamin
Partner
Matheson
T: +353 1 232 2266
E: susanne.mcmenamin@matheson.com

Susanne is a partner in Matheson's Corporate Group specialising in corporate advisory matters and equity capital markets transactions.

A member of Matheson's ESG Advisory Group Susanne has particular expertise in company law and corporate governance advisory work for public and private companies, including assisting clients to embed good corporate governance policies and practices across their organisations.

Susanne advises clients on European securities law, Irish and UK Listing Rules and the Irish Takeover Rules and works with clients on corporate reporting requirements in Ireland.

Susanne provides board induction and ongoing director training on specialist corporate governance, compliance and securities law matters. Susanne also advises on matters of crisis and reputation management.

Susanne has extensive equity capital markets transaction experience advising international and domestic clients on IPOs, capital raisings, public company M&A (hostile and recommended offers) as well as experience on corporate migrations, redomiciliations, joint ventures and reorganisations.

Garret Farrelly
Partner
Matheson
T: +353 1 232 2074
E: garret.farrelly@matheson.com

Garret Farrelly is a partner and Head of both Matheson's Energy, Natural Resources and Utilities Group and Projects and Infrastructure Group. He also chairs Matheson's cross departmental specialist ESG Advisory Group.

Garret advises on all aspects of projects and project financing, from PPPs to privately-financed energy and infrastructure developments and privatisations as well as electricity, gas and telecommunications network infrastructure. Garret's experience also includes project development, M&A and financing in the conventional and renewable electricity sectors.

Garret's practice focuses heavily on electricity market regulation and trading as well as renewable energy projects and sustainability and ESG mandates and transactions. Recent mandates include advising the Irish Government on the Renewable Energy Subsidy Schemes (the RESS 1, RESS Offshore and RESS 2 schemes), advising EirGrid plc and SONI Limited (the all-island transmission system operators) in relation to the re-design of the Irish power market (I-SEM) and advising both corporates and developers on all but one of the renewable energy corporate power purchase agreements which have been signed in Ireland to date. Garret is consistently ranked as a Tier 1 Energy lawyer in Ireland, including in leading legal international directories such as Legal 500, Chambers Europe and IFLR1000.

Tara Doyle
Partner
Matheson
T: +353 1 232 2221
E: tara.doyle@matheson.com

Tara Doyle is a partner and head of the Asset Management and Investment Funds Department at Matheson.

Tara practices Irish financial services law and advises many of the world's leading financial institutions, investment banks, asset management companies, broker-dealers and corporations carrying on business in Ireland or through Irish vehicles.

Tara has extensive experience in advising a wide range of domestic and international clients on the structuring, establishment, marketing and sale of financing and investment vehicles and products in Ireland and other jurisdictions. In particular, she specialises in advising on the legal and regulatory issues surrounding the establishment of private and public investment funds.

Tara is a former Chair of the Irish Funds Industry Association (Irish Funds) and currently serves as Chair of the Irish Funds ESG Policy, Legal & Regulatory Working Group. Tara is also a member of the EFAMA Stewardship, Market Integrity, ESG Investment Standing Committee. Tara is also a member of the IFSC Funds Group established by the Department of An Taoiseach (the Irish Prime Minister) to consider and advise on legislative and other changes which are necessary or desirable to facilitate the continued growth of the Irish investment funds industry.

compared to 52% when a similar review was conducted in March 2020.

Role of corporate governance in ESG

Before now, the 'E' and the 'S' were viewed as being of greater importance than the 'G' in an organisation's ESG focus, but it has now become clear that the 'E', 'S' and 'G' are all intertwined. Before companies can make meaningful progress on environmental and social change, they need the foundation of a strong governance structure.

Risk management sits at the heart of the board responsibilities of every organisation. The board must establish a framework of prudent and effective controls which enable risk to be assessed and managed. ESG is a fundamental risk for almost all businesses in the current climate. It is crucial that boards identify the ESG risks their organisations face. Having considered the risks, boards should work with their management teams to ensure robust internal controls and governance frameworks are established to mitigate those risks.

Boards should then consider what the reporting of ESG risks and strategies is required or expected to address, and mitigate the concerns of stakeholders and investors. In seizing the opportunity to be an early leader in the ESG arena, many organisations have strategically assessed and revised their internal operations, enhancing the approach to a wide range of issues within their business models. Executing ESG initiatives will be an integral part of how the board can drive organisational strategy.

The EU has set its sights on the gender composition of boards with its recent announcement of plans to revive previously-stalled proposals to legislate for gender balance on the boards of listed companies.

In March 2022, EU employment and social affairs ministers agreed a general approach on a proposed directive under which by 2027, listed companies should aim to have at least 40% of their non-executive director positions or 33% of their non-executive and executive director positions held by women.

The ever-changing ESG landscape is a crucial challenge for boards and their organisations. Company directors are expected to step up and will be required to show to the outside world that they bear ultimate responsibility for ESG compliance within their businesses. At the heart of this responsibility lies board oversight, consistent and strong corporate governance, and a clear understanding of the changes coming down the tracks in the ESG space. With early planning, businesses, led by their board, can ensure a smoother transition to the mainstreaming of ESG compliance.

Corporate reporting: The legislative landscape

In the last number of years, the breadth of ESG legislation has significantly grown. The legislative reach of ESG measures extends beyond the typical large multinational corporation and listed company to now capture smaller companies meeting prescribed employee, asset and revenue thresholds.

The EU's appetite for ESG legislation continues unabated with several legislative developments either in the early stages of implementation or in the EU's pipeline. The Commission has set itself ambitious legislative targets in recent years with the expectation that member states and companies, led by their boards, acknowledge the importance of ESG and step up to the mark in ensuring that ESG receives careful consideration.

The monumental acceleration in this area should not be underestimated, warranting early and careful review and attention by businesses. Boards should implement appropriate oversight and governance controls as early as possible.

While it is impossible to cover all aspects of the ESG legislative regime, we have sought to summarise the key measures of particular importance to companies in a range of sectors.

Taxonomy regulation

The EU has sought to legislate for sustainable finance by introducing the Taxonomy Regulation the aim of which is to:

- Encourage the integration of ESG factors into investment decision-making;
- Reduce the fragmentation in sustainable financing practices that exists throughout the EU and to prevent, in particular, greenwashing in financial products (where a lender or borrower inaccurately claims a loan is green or sustainability linked);
- Provides for an EU-wide classification system enabling businesses and investors to assess the degree of sustainability of economic activities; and
- Provide financial market participants with a common language for environmentally sustainable activities and encourage financial investments to businesses engaged in or moving towards more sustainable activities.

The Taxonomy Regulation will also serve as the starting point for other EU sustainability projects in the financial sector, such as the EU Ecolabel, which will be given to financial products with a minimum of 60% of the investments aligned with the Taxonomy Regulation, and the EU Green Bond Standard, described below.

Sustainable Finance Disclosure Regulation

The Sustainable Finance Disclosure Regulation (the SFRD) requires private equity firms, pension funds, hedge funds and other asset managers to consider and disclose in a consistent and harmonised manner how ESG factors are adopted in their decision-making processes. Its main provisions came into effect in March 2021 on a phased basis (Level 1).

It introduced entity and product level sustainability-related disclosure requirements for financial market participants (FMPs) and financial advisers. Its ultimate aim is to harmonise disclosure standards among member states to facilitate the comparability of different financial products and services.

A significant portion of the SFRD applies to all asset managers, whether or not they have an express ESG or sustainability focus. The SFRD manifests in additional disclosures for FMPs: on websites, in prospectuses and in periodic reports. The more detailed requirements relating to disclosures in the periodic reports of ESG-focused products (Level 2) were initially proposed to apply from January 1 2022, but have now been deferred to July 1 2022.

European Green Bond Standard

In July 2021, building on key ESG policy initiatives, the Commission proposed a regulation on a European Green Bond Standard (Standard). In a similar vein to SFDR, the Standard will create a high-quality voluntary standard for bonds financing sustainable investment which will sit alongside existing voluntary standards published by the International Capital Markets Association and other industry bodies. Issuers will have a recognised way of demonstrating that they are funding green

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projects aligned with the EU Taxonomy Regulation. The Standard will be open to any issuer of green bonds, including those located outside the EU.

There are four main requirements under the proposed framework:

- The funds raised by the bond should be allocated fully to projects aligned with the EU Taxonomy Regulation;
- There must be full transparency on how bond proceeds are allocated through detailed reporting requirements;
- All EU green bonds must be checked by an external reviewer to ensure compliance and that funded projects are aligned with the EU Taxonomy Regulation. Specific, limited flexibility is foreseen here for sovereign issuers; and
- External reviewers providing services to issuers of EU green bonds must be registered with and supervised by ESMA.

The proposal is progressing through the EU legislative process with a view to its adoption in 2022.

EU Regulation 2021/1119 ‘Fit For 55’

Regulation 2021/119, establishing a framework for achieving climate neutrality and amending Regulations (EC) No 401/2009 and (EU) 2018/1999 (Fit for 55) was published in July 2021. Its proposal and adoption were fundamental components of the European Green Deal. It is a set of interconnected proposals, strengthening eight pieces of existing legislation and introducing five new initiatives across an array of sectors including climate, energy and fuel, transport, buildings, land use and forestry.

Fit for 55 refers to the binding objective to reduce greenhouse gas emissions by at least 55% by 2030 as compared to 1990 levels. Proposals include: (i) an enhanced Emissions Trading System; (ii) extending emissions trading to maritime, road transport, and buildings; (iii) an updated Energy Taxation Directive; (iv) a New Carbon Border Adjustment Mechanism; (v) stricter CO2 performance rules for cars and vans; and (viii) higher carbon reduction targets for member states.

TCFD

In 2015, the Task Force on Climate-Related Financial Disclosures (TCFD) was created by the G20’s Financial Stability Board (FSB) to encourage financial institutions and non-financial companies to disclose financially material information on climate-related risks and opportunities. The TCFD published comprehensive recommendations in 2017 and subsequent guidance to assist organisations with the implementation of these recommendations (including guidance on reporting on climate metrics, targets and transition plans).

As of 2022, 3,100+ organisations across 93 jurisdictions have publicly pledged their support for the TCFD recommendations. While the TCFD recommendations are drafted as authoritative guidance, some jurisdictions have sought to mandate the disclosure recommendations for the reporting of financially material climate-related information. New UK legislation (applying to over 1,300 of the largest UK-registered companies) will mandate the disclosure of climate-related financial information. Other jurisdictions are expected to follow suit and seek to integrate the recommendations into their legislative and policy frameworks.

Non-Financial Reporting Directive

The Non-Financial Reporting Directive (the NFRD), which amended the existing Accounting Directive 2013/34/EU, obliged certain companies to make annual disclosures on certain non-financial and board diversity matters.

Approximately 11,000 companies are currently covered by the NFRD which obliges in-scope companies to disclose information on the way they engage with social and environmental challenges. Its aim is to enable investors, consumers and other stakeholders to evaluate the non-financial performance of companies, leading to overall improved sustainability outcomes. Currently, reporting requirements under the NFRD apply to large ‘public interest entities’ (meaning listed companies, banks, and insurance companies) with more than 500 employees.

The required disclosures are included in the directors’ report of a company which accompanies the annual statutory financial statements (however, in certain circumstances, in the case of the non-financial matters, disclosures can be made using an alternative method of publication on a company’s website). Disclosures are incorporated in the directors’ report, further demonstrating the need for prudent corporate governance and board oversight as the overall responsibility rests with the board in this regard.

Corporate Sustainability Reporting Directive

In April 2021, the European Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD) which seeks to amend the current NFRD and would oblige companies in scope to

report against common EU sustainability reporting standards. If introduced, a much greater number of companies across the EU will be brought within the sustainability reporting regime for the very first time. Reporting will be in line with the SFRD and the Taxonomy Regulation.

The CSRD proposal comes in the wake of calls for greater consistency and transparency in corporate sustainability reporting and aims to address perceived gaps in the operation of the NFRD. The CSRD proposes to harmonise sustainability reporting standards to ensure companies provide reliable, comparable and relevant information on sustainability risks, opportunities and impacts. The change in terminology from 'non-financial' in the NFRD to 'sustainability' in the CSRD signals the policy shift in recognising sustainability as core to financial outcomes.

The CSRD will apply to all large companies governed by the law of, or established in, an EU member state and EU stock exchange-listed companies (except listed micro-companies). Approximately 49,000 companies will be in scope. A large company is one meeting two out three of the following criteria: at least 250 employees; annual turnover exceeding €40 million; and assets exceeding €20 million. Listed SMEs will become subject to sustainability reporting obligations but will have an extra three years to comply.

The introduction of the CSRD will see a significant deepening and expansion of existing disclosure requirements. Companies must not only disclose how sustainability issues impact the company (impacts inward), but also how the company impacts society and the environment (impacts outward) – the 'Double Materiality' concept.

Companies will be obliged to report on issues such as: the plans to ensure that business models and strategies are compatible with the transition to a sustainable economy and with the aim of limiting global warming to 1.5°C under the Paris Climate Agreement; sustainability targets and progress made to achieve those targets; roles and responsibilities of management; adverse impacts connected with the company's value chain; and principal risks related to sustainability matters. The disclosed information must be qualitative and quantitative in nature, both forward-looking and retrospective, and covers short, medium and long-term time horizons.

Another key development under the CSRD is the introduction of a general EU-wide audit (assurance) requirement for reported sustainability information. Limited in scope at first; over time, the assurance obligation is intended to become more demanding, eventually mirroring the level applicable to financial reporting. The proposal allows individual member states to open up the market for sustainability assurance services to 'independent assurance services providers'.

In terms of timing, the Commission plans to adopt the CSRD in late 2022. Companies are likely to start reporting to the new standards in 2024 based on FY2023 information (with SMEs allowed an additional three years to comply). At the time of writing, there are proposals to delay the application of CSRD, but there are differing views on the desirability and likelihood of such a delay.

Directive on Corporate Sustainability Due Diligence

On February 23 2022, the Commission published a proposal for a Directive on Corporate Sustainability Due Diligence (the CSDD) that would establish a corporate sustainability due diligence duty on large companies operating in the EU. This duty will require companies to undertake due diligence checks of their supply chain to identify actual and potential adverse impacts of their activities on the environment, climate change and human rights. The CSDD will substantially complement the SFDR and Taxonomy Regulation and will cover about 13,000 EU companies.

The key objectives for the CSDD are to:

- Improve corporate governance practices, to better integrate risk management and mitigation processes of environmental, climate change and human rights risks and impacts, including those stemming from value chains, into corporate strategies;
- Avoid fragmentation of due diligence requirements in the single market and create legal certainty for businesses and stakeholders as regards expected behaviour and liability;
- Increase corporate accountability (especially accountability of executive management) for adverse impacts, and ensure coherence for companies regarding obligations under the existing and proposed EU initiatives; and
- Improve access to remedies for those affected by adverse environmental, climate change and human rights impacts of corporate behaviour.

The overall responsibility for overseeing the implementation of the due diligence processes will rest with the board of directors and the legislation will impose duties on directors for overseeing the integration of sustainability due diligence into their corporate structures.

Despite being at the EU approval stage, the CSDD has been in the pipeline for some time and it is anticipated that EU legislative bodies will prioritise its implementation. Once adopted, member states will have two years to transpose the CSDD into national law.

Conclusion

The Commission recognises that it is in the interests of the EU and European companies and investors to have ESG standards that are globally aligned. EU standards should aim to incorporate the essential elements of globally accepted standards currently being developed.

These legislative developments are representative of the growing focus, and indeed scrutiny, on ESG at a global and national policy level. Consumer and investor pressure on businesses, together with these legislative initiatives, are key drivers behind sustainability policy changes within organisations today.

The impacts of recent ESG measures may be financially material and may necessitate significant changes to a company's fundamental strategy and business model. Policies that have science-based, targeted initiatives and contain solid, transparent goals that are externally validated are more likely to succeed. In preparing such policies and managing the required disclosures, boards and management are reminded of the importance of ESG for the business's future success.

The overwhelming factor for successful ESG reporting is a well-structured board that possesses the necessary acumen to ensure ESG risks, controls and processes are managed appropriately. Boards need to be proactive, prepared and well-informed; whole-heartedly accept the responsibility that rests with them and pay careful consideration to the impact their decisions will have on ESG matters.